

value of \$100 and no liabilities. T's shareholders have an aggregate basis of \$50 in T's stock. Pursuant to a plan, P forms S and S acquires all of T's stock in exchange for P stock in a transaction described in section 368(a)(1)(B). The transaction is also a reverse acquisition under §1.1502-75(d)(3). Thus, the transaction is a group structure change under §1.1502-33(f)(1), and the earnings and profits of P and S are adjusted to reflect T's earnings and profits immediately before T ceases to be the common parent of the T group.

(b) *Analysis.* Under paragraph (d)(4) of this section, although S is not the new common parent of the T group, adjustments must be made to S's basis in T's stock in accordance with the principles of this section. Although S's basis in T's stock would ordinarily be determined under section 362 by reference to the basis of T's shareholders in T's stock immediately before the group structure change, under the principles of paragraph (b)(2) of this section, S's basis in T's stock is determined by reference to T's net asset basis. Thus, S's basis in T's stock is \$60.

(c) *Higher-tier adjustments.* Under paragraph (d)(4) of this section, P's basis in S's stock is adjusted to \$60 (to be consistent with the adjustment to S's basis in T's stock).

(d) *Cross ownership.* The facts are the same as in paragraph (a) of this *Example 2*, except that S has owned 10% of T's stock for several years and, pursuant to the plan, S acquires the remaining 90% of T's stock in exchange for P stock. The results are the same as in paragraphs (b) and (c) of this *Example 2*, because S's basis in the initial 10% of T's stock is redetermined under this section.

(e) *Allocable share.* The facts are the same as in paragraph (a) of this *Example 2*, except that P owns only 90% of S's stock immediately after the group structure change. S's basis in T's stock is the same as in paragraph (b) of this *Example 2*. Under paragraph (d)(2) of this section, P's basis in its S stock is adjusted to \$54 (90% of S's \$60 adjustment).

*Example 3. Taxable stock acquisition.* (a) *Facts.* P is the common parent of one group and T is the common parent of another. T has assets with an aggregate basis of \$60 and fair market value of \$100 and no liabilities. T's shareholders have an aggregate basis of \$50 in T's stock. Pursuant to a plan, P acquires all of T's stock in exchange for \$70 of P's stock and \$30 in a transaction that is a group structure change under §1.1502-33(f)(1). P's acquisition of T's stock is a taxable transaction. (Because of P's use of cash, the acquisition is not a transaction described in section 368(a)(1)(B).)

(b) *Analysis.* Under paragraph (b)(2) of this section, P's basis in T's stock is adjusted to reflect T's net asset basis. Thus, although P's basis in T's stock would ordinarily be a cost basis of \$100, P's basis in T's stock under this section is \$60.

(h) *Effective date—(1) General rule.* This section applies to group structure changes occurring in consolidated return years beginning on or after January 1, 1995.

(2) *Prior law.* For prior years, see prior regulations under section 1502 as in effect with respect to the transaction. See, e.g., §1.1502-31T as contained in the 26 CFR part 1 edition revised as of April 1, 1994.

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**§ 1.1502-32 Investment adjustments.**

(a) *In general—(1) Purpose.* This section provides rules for adjusting the basis of the stock of a subsidiary (S) owned by another member (P). These rules modify the determination of P's basis in S's stock under applicable rules of law by adjusting P's basis to reflect S's distributions and S's items of income, gain, deduction, and loss taken into account for the period that S is a member of the consolidated group. The purpose of the adjustments is to treat P and S as a single entity so that consolidated taxable income reflects the group's income. For example, if P forms S with a \$100 contribution, and S takes into account \$10 of income, P's \$100 basis in S's stock under section 358 is increased by \$10 under this section to prevent S's income from being taken into account a second time on P's disposition of S's stock. Comparable adjustments are made for tax-exempt income and noncapital, non-deductible expenses that S takes into account, to preserve their treatment under the Internal Revenue Code.

(2) *Application of other rules of law.* The rules of this section are in addition to other rules of law. See, e.g., section 358 (basis determinations for distributees), section 1016 (adjustments to basis), §1.1502-11(b) (limitations on the use of losses), §1.1502-19 (treatment of excess loss accounts), §1.1502-20 (additional rules relating to stock loss), and §1.1502-31 (basis after a group structure change). P's basis in S's stock must not be adjusted under this section and other rules of law in a manner that has the effect of duplicating an adjustment. See also paragraph (h)(5) of this section for basis reductions applicable to certain former subsidiaries.

(3) *Overview*—(i) *In general.* The amount of the stock basis adjustments and their timing are determined under paragraph (b) of this section. Under paragraph (c) of this section, the amount of the adjustment is allocated among the shares of S's stock. Paragraphs (d) through (g) of this section provide definitions, an anti-avoidance rule, successor rules, and record-keeping requirements.

(ii) *Excess loss account.* Negative adjustments under this section may exceed P's basis in S's stock. The resulting negative amount is P's excess loss account in S's stock. See § 1.1502-19 for rules treating excess loss accounts as negative basis, and treating references to stock basis as including references to excess loss accounts.

(iii) *Tiering up of adjustments.* The adjustments to S's stock under this section are taken into account in determining adjustments to higher-tier stock. The adjustments are applied in the order of the tiers, from the lowest to the highest. For example, if P is also a subsidiary, P's adjustment to S's stock is taken into account in determining the adjustments to stock of P owned by other members.

(b) *Stock basis adjustments*—(1) *Timing of adjustments*—(i) *In general.* Adjustments under this section are made as of the close of each consolidated return year, and as of any other time (an interim adjustment) if a determination at that time is necessary to determine a tax liability of any person. For example, adjustments are made as of P's sale of S's stock in order to measure P's gain or loss from the sale, and if P's interest in S's stock is not uniform throughout the year (e.g., because P disposes of a portion of its S stock, or S issues additional shares to another person), the adjustments under this section are made by taking into account the varying interests. An interim adjustment may be necessary even if tax liability is not affected until a later time. For example, if P sells only 50% of S's stock and S becomes a nonmember, adjustments must be made for the retained stock as of the disposition (whether or not P has an excess loss account in that stock). Similarly, if S liquidates during a consolidated return year, adjustments

must be made as of the liquidation (even if the liquidation is tax free under section 332).

(ii) *Allocation of items.* If § 1.1502-76(b) applies to S for purposes of an adjustment before the close of the group's consolidated return year, the amount of the adjustment is determined under that section. If § 1.1502-76(b) does not apply to the interim adjustment, the adjustment is determined under the principles of § 1.1502-76(b), consistently applied, and ratable allocation under the principles of § 1.1502-76(b)(2)(ii) or (iii) may be used without filing an election under § 1.1502-76(b)(2). The principles would apply, for example, if P becomes a nonmember but S remains a member.

(2) *Amount of adjustments.* P's basis in S's stock is increased by positive adjustments and decreased by negative adjustments under this paragraph (b)(2). The amount of the adjustment, determined as of the time of the adjustment, is the net amount of S's—

- (i) Taxable income or loss;
- (ii) Tax-exempt income;
- (iii) Noncapital, nondeductible expenses; and
- (iv) Distributions with respect to S's stock.

(3) *Operating rules.* For purposes of determining P's adjustments to the basis of S's stock under paragraph (b)(2) of this section—

(i) *Taxable income or loss.* S's taxable income or loss is consolidated taxable income (or loss) determined by including only S's items of income, gain, deduction, and loss taken into account in determining consolidated taxable income (or loss), treating S's deductions and losses as taken into account to the extent they are absorbed by S or any other member. For this purpose:

(A) To the extent that S's deduction or loss is absorbed in the year it arises or is carried forward and absorbed in a subsequent year (e.g., under section 172, 465, or 1212), the deduction or loss is taken into account under paragraph (b)(2) of this section in the year in which it is absorbed.

(B) To the extent that S's deduction or loss is carried back and absorbed in a prior year (whether consolidated or separate), the deduction or loss is taken into account under paragraph

(b)(2) of this section in the year in which it arises and not in the year in which it is absorbed.

(ii) *Tax-exempt income*—(A) *In general.* S's tax-exempt income is its income and gain which is taken into account but permanently excluded from its gross income under applicable law, and which increases, directly or indirectly, the basis of its assets (or an equivalent amount). For example, S's dividend income to which § 1.1502-13(f)(2)(ii) applies, and its interest excluded from gross income under section 103, are treated as tax-exempt income. However, S's income not recognized under section 1031 is not treated as tax-exempt income because the corresponding basis adjustments under section 1031(d) prevent S's nonrecognition from being permanent. Similarly, S's tax-exempt income does not include gain not recognized under section 332 from the liquidation of a lower-tier subsidiary, or not recognized under section 118 or section 351 from a transfer of assets to S.

(B) *Equivalent deductions.* To the extent that S's taxable income or gain is permanently offset by a deduction or loss that does not reduce, directly or indirectly, the basis of S's assets (or an equivalent amount), the income or gain is treated as tax-exempt income and is taken into account under paragraph (b)(3)(ii)(A) of this section. In addition, the income and the offsetting item are taken into account under paragraph (b)(3)(i) of this section. For example, if S receives a \$100 dividend with respect to which a \$70 dividends received deduction is allowed under section 243, \$70 of the dividend is treated as tax-exempt income. Accordingly, P's basis in S's stock increases by \$100 because the \$100 dividend and \$70 deduction are taken into account under paragraph (b)(3)(i) of this section (resulting in \$30 of the increase), and \$70 of the dividend is also taken into account under paragraph (b)(3)(ii)(A) of this section as tax-exempt income (resulting in \$70 of the increase). (See paragraph (b)(3)(iii) of this section if there is a corresponding negative adjustment under section 1059.) Similarly, income from mineral properties is treated as tax-exempt income to the extent it is offset

by deductions for depletion in excess of the basis of the property.

(C) *Discharge of indebtedness income*—(1) *In general.* Discharge of indebtedness income of S that is excluded from gross income under section 108 is treated as tax-exempt income only to the extent the discharge is applied to reduce tax attributes (e.g., under section 108 or 1017). Discharge of S's indebtedness is treated as applied to reduce tax attributes only to the extent the attribute reduction is taken into account as a reduction under paragraph (b)(3)(iii) of this section.

(2) *Expired loss carryovers.* If the amount of the discharge exceeds the amount of the attribute reduction, the excess is nevertheless treated as applied to reduce tax attributes to the extent a loss carryover expired without tax benefit, the expiration was taken into account as a noncapital, nondeductible expense under paragraph (b)(3)(iii) of this section, and the loss carryover would have been reduced had it not expired.

(D) *Basis shifts.* An increase in the basis of S's assets (or an equivalent as described in paragraph (b)(3)(iv)(B) of this section) is treated as tax-exempt income to the extent that the increase is not otherwise taken into account in determining stock basis, it corresponds to a negative adjustment that is taken into account by the group under this paragraph (b) (or incurred by the common parent), and it has the effect (viewing the group in the aggregate) of a permanent recovery of the reduction. For example, S's basis increase under section 50(c)(2) is treated as tax-exempt income to the extent the preceding basis reduction under section 50(c)(1) is reflected in the basis of a member's stock. On the other hand, if S increases the basis of an asset as the result of an accounting method change, and the related positive section 481(a) adjustment is taken into account over time, the basis increase is not treated as tax-exempt income.

(iii) *Noncapital, nondeductible expenses*—(A) *In general.* S's noncapital, nondeductible expenses are its deductions and losses that are taken into account but permanently disallowed or eliminated under applicable law in determining its taxable income or loss,

and that decrease, directly or indirectly, the basis of its assets (or an equivalent amount). For example, S's Federal taxes described in section 275 and loss not recognized under section 311(a) are noncapital, nondeductible expenses. Similarly, if a loss carryover (e.g., under section 172 or 1212) attributable to S expires or is reduced under section 108(b), it becomes a noncapital, nondeductible expense at the close of the last tax year to which it may be carried. However, if S sells and repurchases a security subject to section 1091, the disallowed loss is not a noncapital, nondeductible expense because the corresponding basis adjustments under section 1091(d) prevent the disallowance from being permanent.

(B) *Nondeductible basis recovery.* Any other decrease in the basis of S's assets (or an equivalent as described in paragraph (b)(3)(iv)(B) of this section) may be a noncapital, nondeductible expense to the extent that the decrease is not otherwise taken into account in determining stock basis and is permanently eliminated for purposes of determining S's taxable income or loss. Whether a decrease is so treated is determined by taking into account both the purposes of the Code or regulatory provision resulting in the decrease and the purposes of this section. For example, S's noncapital, nondeductible expenses include any basis reduction under section 50(c)(1), section 1017, section 1059, § 1.1502-20(b), or § 1.1502-20(g). Also included as a noncapital, nondeductible expense is the amount of any gross-up for taxes paid by another taxpayer that S is treated as having paid (e.g., income included under section 78, or the portion of an undistributed capital gain dividend that is treated as tax deemed to have been paid by a shareholder under section 852(b)(3)(D)(ii), whether or not any corresponding amount is claimed as a tax credit). In contrast, a decrease generally is not a noncapital, nondeductible expense if it results because S redeems stock in a transaction to which section 302(a) applies, S receives assets in a liquidation to which section 332 applies and its basis in the assets is less than its basis in the stock canceled, or S distributes the stock of a subsidiary in a distribution to which section 355 applies.

(iv) *Special rules for tax-exempt income and noncapital, nondeductible expenses.* For purposes of paragraphs (b)(3)(ii) and (iii) of this section:

(A) *Treatment as permanent.* An amount is permanently excluded from gross income, or permanently disallowed or eliminated, if it is so treated by S even though another person may take a corresponding amount into account. For example, if S sells property to a nonmember at a loss that is disallowed under section 267(a), S's loss is a noncapital, nondeductible expense even though under section 267(d) the nonmember may treat a corresponding amount of gain as not recognized. (If the nonmember is a subsidiary in another consolidated group, its gain not recognized under section 267(d) is tax-exempt income under paragraph (b)(3)(ii)(A) of this section.)

(B) *Amounts equivalent to basis and adjustments to basis.* Amounts equivalent to basis include the amount of money, the amount of a loss carryover, and the amount of an adjustment to gain or loss under section 475(a) for securities described in section 475(a)(2). An equivalent to a basis increase includes a decrease in an excess loss account, and an equivalent to a basis decrease includes the denial of basis for taxable income.

(C) *Timing.* An amount is taken into account in the year in which it would be taken into account under paragraph (b)(3)(i) of this section if it were subject to Federal income taxation.

(D) *Tax sharing agreements.* Taxes are taken into account by applying the principles of section 1552 and the percentage method under § 1.1502-33(d)(3) (and by assuming a 100% allocation of any decreased tax liability). The treatment of amounts allocated under this paragraph (b)(3)(iv)(D) is analogous to the treatment of allocations under § 1.1552-1(b)(2). For example, if one member owes a payment to a second member, the first member is treated as indebted to the second member. The right to receive payment is treated as a positive adjustment under paragraph (b)(3)(ii) of this section, and the obligation to make payment is treated as a negative adjustment under paragraph (b)(3)(iii) of this section. If the obligation is not paid, the amount not paid generally is treated as a distribution,

contribution, or both, depending on the relationship between the members.

(v) *Distributions.* Distributions taken into account under paragraph (b)(2) of this section are distributions with respect to S's stock to which section 301 applies and all other distributions treated as dividends (e.g., under section 356(a)(2)). See § 1.1502-13(f)(2)(iv) for taking into account distributions to which section 301 applies (but not other distributions treated as dividends) under the entitlement rule.

(4) *Waiver of loss carryovers from separate return limitation years—(i) General rule.* If S has a loss carryover from a separate return limitation year when it becomes a member of a consolidated group, the group may make an irrevocable election to treat all or any portion of the loss carryover as expiring for all Federal income tax purposes immediately before S becomes a member of the consolidated group (deemed expiration). If S was a member of another group immediately before it became a member of the consolidated group, the expiration is also treated as occurring immediately after it ceases to be a member of the prior group.

(ii) *Stock basis adjustments from a waiver—(A) Qualifying transactions.* If S becomes a member of the consolidated group in a qualifying cost basis transaction and an election under this paragraph (b)(4) is made, the noncapital, nondeductible expense resulting from the deemed expiration does not result in a corresponding stock basis adjustment for any member under this section. A qualifying cost basis transaction is the purchase (i.e., a transaction in which basis is determined under section 1012) by members of the acquiring consolidated group (while they are members) in a 12-month period of an amount of S's stock satisfying the requirements of section 1504(a)(2).

(B) *Nonqualifying transactions.* If S becomes a member of the consolidated group other than in a qualifying cost basis transaction and an election under this paragraph (b)(4) is made, the basis of its stock that is owned by members immediately after it becomes a member is subject to reduction under the principles of this section to reflect the deemed expiration. The reduction oc-

curs immediately before S becomes a member, but after it ceases to be a member of any prior group, and it therefore does not result in a corresponding stock basis adjustment for any higher-tier member of the transferring or acquiring consolidated group. Any basis reduction under this paragraph (b)(4)(ii)(B) is taken into account in making determinations of basis under the Code with respect to S's stock (e.g., a determination under section 362 because the stock is acquired in a transaction described in section 368(a)(1)(B)), but it does not result in corresponding stock basis adjustments under this section for any higher-tier member. If the basis reduction exceeds the basis of S's stock, the excess is treated as an excess loss account to which the members owning S's stock succeed.

(C) *Higher-tier corporations.* If S becomes a member of the consolidated group as a result, in whole or in part, of a higher-tier corporation becoming a member (whether or not in a qualifying cost basis transaction), additional adjustments are required. The highest-tier corporation (T) whose becoming a member resulted in S becoming a member, and T's chain of lower-tier corporations that includes S, are subject to the adjustment. The deemed expiration of S's loss carryover that results in a negative adjustment for the first higher-tier corporation is treated as an expiring loss carryover of that higher-tier corporation for purposes of applying paragraph (b)(4)(ii)(B) of this section to that corporation. For example, if P purchases all of the stock of T, T owns all of the stock of T1, T1 owns all of the stock of S, S becomes a member as a result of T becoming a member, and the election under this paragraph (b)(4) is made, the basis of the S stock is reduced and the reduction tiers up to T1, T1 treats the negative adjustment to its basis in S's stock as an expiring loss carryover of T1, and T then adjusts its basis in T1's stock. In addition, if T becomes a member of the acquiring group in a transaction other than a qualifying cost basis transaction, the amount that tiers up to T also reduces the basis of its stock under paragraph (b)(4)(ii)(B) of this section (but the

amount does not tier up to higher-tier members).

(iii) *Net asset basis limitation.* Basis reduced under this paragraph (b)(4) is restored before S becomes a member (and before the basis of S's stock is taken into account in determining basis under the Code) to the extent necessary to conform a share's basis to its allocable portion of net asset basis. In the case of higher-tier corporations under paragraph (b)(4)(ii)(C) of this section, the restoration does not tier up but is instead applied separately to each higher-tier corporation. For purposes of determining each corporation's net asset basis (including the basis of stock in lower-tier corporations), the restoration is applied in the order of tiers, from the lowest to the highest. For purposes of the restoration:

(A) A member's net asset basis is the positive or negative difference between the adjusted basis of its assets (and the amount of any of its loss carryovers that are not deemed to expire) and its liabilities. Appropriate adjustments must be made, for example, to disregard liabilities that subsequently will give rise to deductions (e.g., liabilities to which section 461(h) applies).

(B) Within a class of stock, each share has the same allocable portion of net asset basis. If there is more than one class of common stock, the net asset basis is allocated to each class by taking into account the terms of each class and all other facts and circumstances relating to the overall economic arrangement.

(iv) *Election.* The election described in this paragraph (b)(4) must be made in a separate statement entitled "ELECTION TO TREAT LOSS CARRYOVER AS EXPIRING UNDER § 1.1502-32(b)(4)." The statement must be filed with the consolidated group's return for the year S becomes a member, and it must be signed by the common parent and S. A separate statement must be made for each member whose loss carryover is deemed to expire. The statement must identify the amount of each loss carryover deemed to expire (or the amount of each loss carryover deemed not to expire, with any balance of any loss carryovers being deemed to expire), the basis of any stock reduced

as a result of the deemed expiration, and the computation of the basis reduction.

(5) *Examples*—(i) *In general.* For purposes of the examples in this section, unless otherwise stated, P owns all of the only class of S's stock, the stock is owned for the entire year, S owns no stock of lower-tier members, the tax year of all persons is the calendar year, all persons use the accrual method of accounting, the facts set forth the only corporate activity, preferred stock is described in section 1504(a)(4), all transactions are between unrelated persons, and tax liabilities are disregarded.

(ii) *Stock basis adjustments.* The principles of this paragraph (b) are illustrated by the following examples.

*Example 1. Taxable income.* (a) *Current taxable income.* For Year 1, the P group has \$100 of taxable income when determined by including only S's items of income, gain, deduction, and loss taken into account. Under paragraph (b)(1) of this section, P's basis in S's stock is adjusted under this section as of the close of Year 1. Under paragraph (b)(2) of this section, P's basis in S's stock is increased by the amount of the P group's taxable income determined by including only S's items taken into account. Thus, P's basis in S's stock is increased by \$100 as of the close of Year 1.

(b) *Intercompany gain that is not taken into account.* The facts are the same as in paragraph (a) of this *Example 1*, except that S also sells property to another member at a \$25 gain in Year 1, the gain is deferred under § 1.1502-13 and taken into account in Year 3, and P sells 10% of S's stock to nonmembers in Year 2. Under paragraph (b)(3)(i) of this section, S's deferred gain is not additional taxable income for Year 1 or 2 because it is not taken into account in determining the P group's consolidated taxable income for either of those years. The deferred gain is not tax-exempt income under paragraph (b)(3)(ii) of this section because it is not permanently excluded from S's gross income. The deferred gain does not result in a basis adjustment until Year 3, when it is taken into account in determining the P group's consolidated taxable income. Consequently, P's basis in the S shares sold is not increased to reflect S's gain from the intercompany sale of the property. In Year 3, the deferred gain is taken into account, but the amount allocable to the shares sold by P does not increase their basis because these shares are held by nonmembers.

(c) *Intercompany gain taken into account.* The facts are the same as in paragraph (b) of this *Example 1*, except that P sells all of S's

stock in Year 2 (rather than only 10%). Under § 1.1502-13, S takes the \$25 gain into account immediately before S becomes a nonmember. Thus, P's basis in S's stock is increased to reflect S's gain from the intercompany sale of the property.

**Example 2. Tax loss.** (a) *Current absorption.* For Year 2, the P group has a \$50 consolidated net operating loss when determined by taking into account only S's items of income, gain, deduction, and loss. S's loss is absorbed by the P group in Year 2, offsetting P's income for that year. Under paragraph (b)(3)(i)(A) of this section, because S's loss is absorbed in the year it arises, P has a \$50 negative adjustment with respect to S's stock. Under paragraph (b)(2) of this section, P reduces its basis in S's stock by \$50. Under paragraph (a)(3)(ii) of this section, if the decrease exceeds P's basis in S's stock, the excess is P's excess loss account in S's stock.

(b) *Interim determination from stock sale.* The facts are the same as in paragraph (a) of this Example 2, except that S's Year 2 loss arises in the first half of the calendar year, P sells 50% of S's stock on July 1 of Year 2, and P's income for Year 2 does not arise until after the sale of S's stock. P's income for Year 2 (exclusive of the sale of S's stock) is offset by S's loss, even though the income arises after the stock sale, and no loss remains to be apportioned to S. See §§ 1.1502-11 and 1.1502-21(b). Under paragraph (b)(3)(i)(A) of this section, because S's \$50 loss is absorbed in the year it arises, it reduces P's basis in the S shares sold by \$25 immediately before the stock sale. Because S becomes a nonmember, the loss also reduces P's basis in the retained S shares by \$25 immediately before S becomes a nonmember. See also § 1.1502-20(b) (possible stock basis reduction on the deconsolidation of S).

(c) *Loss carryback.* The facts are the same as in paragraph (a) of this Example 2, except that P has no income or loss for Year 2, S's \$50 loss is carried back and absorbed by the P group in Year 1 (offsetting the income of P or S), and the P group receives a \$17 tax refund in Year 2 that is paid to S. Under paragraph (b)(3)(i)(B) of this section, because the \$50 loss is carried back and absorbed in Year 1, it is treated as a tax loss for Year 2 (the year in which it arises). Under paragraph (b)(3)(ii) of this section, the refund is treated as tax-exempt income of S. Under paragraph (b)(3)(iv)(C) of this section, the tax-exempt income is taken into account in Year 2 because that is the year it would be taken into account under S's method of accounting if it were subject to Federal income taxation. Thus, under paragraph (b)(2) of this section, P reduces its basis in S's stock by \$33 as of the close of Year 2 (the \$50 tax loss, less the \$17 tax refund).

(d) *Loss carryforward.* The facts are the same as in paragraph (a) of this Example 2, except that P has no income or loss for Year

2, and S's loss is carried forward and absorbed by the P group in Year 3 (offsetting the income of P or S). Under paragraph (b)(3)(i)(A) of this section, the loss is not treated as a tax loss under paragraph (b)(2) of this section until Year 3.

**Example 3. Tax-exempt income and noncapital, nondeductible expenses.** (a) *Facts.* For Year 1, the P group has \$500 of consolidated taxable income. However, the P group has a \$100 consolidated net operating loss when determined by including only S's items of income, gain, deduction, and loss taken into account. Also for Year 1, S has \$80 of interest income that is permanently excluded from gross income under section 103, and S incurs \$60 of related expense for which a deduction is permanently disallowed under section 265.

(b) *Analysis.* Under paragraph (b)(3)(i)(A) of this section, S has a \$100 tax loss for Year 1. Under paragraph (b)(3)(ii)(A) of this section, S has \$80 of tax-exempt income. Under paragraph (b)(3)(iii)(A) of this section, S has \$60 of noncapital, nondeductible expense. Under paragraph (b)(3)(iv)(C) of this section, the tax-exempt income and noncapital, nondeductible expense are taken into account in Year 1 because that is the year they would be taken into account under S's method of accounting if they were subject to Federal income taxation. Thus, under paragraph (b) of this section, P reduces its basis in S's stock as of the close of Year 1 by an \$80 net amount (the \$100 tax loss, less \$80 of tax-exempt income, plus \$60 of noncapital, nondeductible expenses).

**Example 4. Discharge of indebtedness.** (a) *Facts.* P forms S on January 1 of Year 1 and S borrows \$200. During Year 1, S's assets decline in value and the P group has a \$100 consolidated net operating loss when determined by including only S's items of income, gain, deduction, and loss taken into account. None of the loss is absorbed by the group in Year 1, and S is discharged from \$100 of indebtedness at the close of Year 1. Under section 108(a), S's \$100 of discharge of indebtedness income is excluded from gross income because of insolvency. Under section 108(b), S's \$100 net operating loss is reduced to zero at the close of Year 1.

(b) *Analysis.* Under paragraph (b)(3)(iii)(B) of this section, the reduction of the net operating loss is treated as a noncapital, nondeductible expense in Year 1 because the net operating loss is permanently disallowed by section 108(b). Under paragraph (b)(3)(ii)(C) of this section, all \$100 of S's discharge of indebtedness income is treated as tax-exempt income in Year 1 because the discharge results in a \$100 reduction to S's net operating loss. Consequently, the loss and the cancellation of the indebtedness result in no net adjustment to P's basis in S's stock under paragraph (b) of this section. (If the basis of assets were reduced under section 1017, rather than S's loss, the reduction would not

occur until the beginning of Year 2 and the discharge would not be treated as tax-exempt income until that time.)

(c) *Insufficient attributes.* The facts are the same as in paragraph (a) of this *Example 4*, except that \$70 of S's net operating loss is absorbed in Year 1, offsetting P's income for that year, and the indebtedness is discharged at the beginning of Year 2. Under paragraph (b) of this section, the \$70 of S's loss absorbed in Year 1 reduces P's basis in S's stock by \$70 as of the close of Year 1. Under section 108(a), S's discharge of indebtedness income in Year 2 is excluded from the P group's gross income because of insolvency. Under section 108(b), the remaining \$30 of S's net operating loss carryover from Year 1 is reduced to zero at the close of Year 2. No other attributes are reduced. Under paragraph (b)(3)(iii)(B) of this section, the elimination of the remaining \$30 net operating loss by section 108(b) is treated as a noncapital, nondeductible expense. Under paragraph (b)(3)(ii)(C) of this section, only \$30 of the discharge is treated as tax-exempt income because only that amount is applied to reduce tax attributes. See also § 1.1502-19(c)(1)(iii) (taking into account any excess loss account of P in S's stock). The remaining \$70 of discharge income excluded under section 108(a) has no effect on P's basis in S's stock.

(d) *Purchase price adjustment.* Assume instead that S buys land in Year 1 in exchange for S's \$100 purchase money note (bearing interest at a market rate of interest in excess of the applicable Federal rate, and providing for a principal payment at the end of Year 10), and the seller agrees with S in Year 4 to discharge \$60 of the note as a purchase price adjustment to which section 108(e)(5) applies. S has no discharge of indebtedness income that is treated as tax-exempt income under paragraph (b)(3)(ii) of this section. In addition, the \$60 purchase price adjustment is not a noncapital, nondeductible expense under paragraph (b)(3)(iii) of this section. A purchase price adjustment is not equivalent to a discharge of indebtedness that is offset by a deduction or loss. Consequently, the purchase price adjustment results in no net adjustment to P's basis in S's stock under paragraph (b) of this section.

*Example 5. Distributions.* (a) *Amounts declared and distributed.* For Year 1, the P group has \$120 of consolidated taxable income when determined by including only S's items of income, gain, deduction, and loss taken into account. S declares and makes a \$10 dividend distribution to P at the close of Year 1. Under paragraph (b) of this section, P increases its basis in S's stock as of the close of Year 1 by a \$110 net amount (\$120 of taxable income, less a \$10 distribution).

(b) *Distributions in later years.* The facts are the same as in paragraph (a) of this *Example 5*, except that S does not declare and dis-

tribute the \$10 until Year 2. Under paragraph (b) of this section, P increases its basis in S's stock by \$120 as of the close of Year 1, and decreases its basis by \$10 as of the close of Year 2. (If P were also a subsidiary, the basis of its stock would also be increased in Year 1 to reflect P's \$120 adjustment to basis of S's stock; the basis of P's stock would not be changed as a result of S's distribution in Year 2, because P's \$10 of tax-exempt dividend income under paragraph (b)(3)(ii) of this section would be offset by the \$10 negative adjustment to P's basis in S's stock for the distribution.)

(c) *Amounts declared but not distributed.* The facts are the same as in paragraph (a) of this *Example 5*, except that, during December of Year 1, S declares (and P becomes entitled to) another \$70 dividend distribution with respect to its stock, but P does not receive the distribution until after it sells all of S's stock at the close of Year 1. Under § 1.1502-13(f)(2)(iv), S is treated as making a \$70 distribution to P at the time P becomes entitled to the distribution. (If S is distributing an appreciated asset, its gain under section 311 is also taken into account under paragraph (b)(3)(i) of this section at the time P becomes entitled to the distribution.) Consequently, under paragraph (b) of this section, P increases its basis in S's stock as of the close of Year 1 by only a \$40 net amount (\$120 of taxable income, less two distributions totalling \$80). Any further adjustments after S ceases to be a member and the \$70 distribution is made would be duplicative, because the stock basis has already been adjusted for the distribution. Accordingly, the distribution will not result in further adjustments or gain, even if the distribution is a payment to which section 301(c)(2) or (3) applies.

*Example 6. Reorganization with boot.* (a) *Facts.* P owns all of the stock of S and T. On January 1 of Year 1, P has a \$100 basis in the S stock and a \$60 basis in the T stock. S and T have no items of income, gain, deduction, or loss for Year 1. S and T each have substantial earnings and profits. At the close of Year 1, T merges into S in a reorganization described in section 368(a)(1)(A) (and in section 368(a)(1)(D)). P receives no additional S stock, but does receive \$10 which is treated as a dividend under section 356(a)(2).

(b) *Analysis.* Under section 358, P's basis in the S stock is increased by its basis in the T stock. Under § 1.1502-13(f)(3) the money received is treated as being taken into account immediately after the transaction. Thus, the \$10 is treated as a dividend distribution under section 301 and under paragraph (b)(3)(v) of this section, the \$10 is a distribution to which paragraph (b)(2)(iv) of this section applies. Accordingly, P's basis in the S stock is \$160 immediately after the merger,



which is then decreased by the \$10 distribution taken into account immediately after the transaction, resulting in a basis of \$150.

*Example 7. Tiering up of basis adjustments.* P owns all of S's stock, and S owns all of T's stock. For Year 1, the P group has \$100 of consolidated taxable income when determined by including only T's items of income, gain, deduction, and loss taken into account, and \$50 of consolidated taxable income when determined by including only S's items taken into account. S increases its basis in T's stock by \$100 under paragraph (b) of this section. Under paragraph (a)(3) of this section, this \$100 basis adjustment is taken into account in determining P's adjustments to its basis in S's stock. Thus, P increases its basis in S's stock by \$150 under paragraph (b) of this section.

*Example 8. Allocation of items.* (a) *Acquisition in mid-year.* P is the common parent of a consolidated group, and S is an unaffiliated corporation filing separate returns on a calendar-year basis. P acquires all of S's stock and S becomes a member of the P group on July 1 of Year 1. For the entire calendar Year 1, S has \$100 of ordinary income and under § 1.1502-76(b) \$60 is allocated to the period from January 1 to June 30 and \$40 to the period from July 1 to December 31. Under paragraph (b) of this section, P increases its basis in S's stock by \$40.

(b) *Sale in mid-year.* The facts are the same as in paragraph (a) of this *Example 8*, except that S is a member of the P group at the beginning of Year 1 but ceases to be a member on June 30 as a result of P's sale of S's stock. Under paragraph (b) of this section, P increases its basis in S's stock by \$60 immediately before the stock sale. (P's basis increase would be the same if S became a nonmember because S issued additional shares to nonmembers.)

(c) *Absorption of loss carryovers.* Assume instead that S is a member of the P group at the beginning of Year 1 but ceases to be a member on June 30 as a result of P's sale of S's stock, and a \$100 consolidated net operating loss attributable to S is carried over by the P group to Year 1. The consolidated net operating loss may be apportioned to S for its first separate return year only to the extent not absorbed by the P group during Year 1. Under paragraph (b)(3)(i) of this section, if the loss is absorbed by the P group in Year 1, whether the offsetting income arises before or after P's sale of S's stock, the absorption of the loss carryover is included in the determination of S's taxable income or loss for Year 1. Thus, P's basis in S's stock is adjusted under paragraph (b) of this section to reflect any absorption of the loss by the P group.

*Example 9. Gross-ups.* (a) *Facts.* P owns all of the stock of S, and S owns all of the stock of T, a newly formed controlled foreign corporation that is not a passive foreign invest-

ment company. In Year 1, T has \$100 of subpart F income and pays \$34 of foreign income tax, leaving T with \$66 of earnings and profits. The P group has \$100 of consolidated taxable income when determined by taking into account only S's items (the inclusion under section 951(a), taking into account the section 78 gross-up). As a result of the section 951(a) inclusion, S increases its basis in T's stock by \$66 under section 961(a).

(b) *Analysis.* Under paragraph (b)(3)(i) of this section, S has \$100 of taxable income. Under paragraph (b)(3)(iii)(B) of this section, the \$34 gross-up for taxes paid by T that S is treated as having paid is a noncapital, non-deductible expense (whether or not any corresponding amount is claimed by the P group as a tax credit). Thus, P increases its basis in S's stock under paragraph (b) of this section by the net adjustment of \$66.

(c) *Subsequent distribution.* The facts are the same as in paragraph (a) of this *Example 9*, except that T distributes its \$66 of earnings and profits in Year 2. The \$66 distribution received by S is excluded from S's income under section 959(a) because the distribution represents earnings and profits attributable to amounts that were included in S's income under section 951(a) for Year 1. In addition, S's basis in T's stock is decreased by \$66 under section 961(b). The excluded distribution is not tax-exempt income under paragraph (b)(3)(ii) of this section because of the corresponding reduction to S's basis in T's stock. Consequently, P's basis in S's stock is not adjusted under paragraph (b) of this section for Year 2.

*Example 10. Recapture of tax-exempt items.* (a) *Facts.* S is a life insurance company. For Year 1, the P group has \$200 of consolidated taxable income, determined by including only S's items of income, gain, deduction, and loss taken into account (including a \$300 small company deduction under section 806). In addition, S has \$100 of tax-exempt interest income, \$60 of which is S's *company share*. The remaining \$40 of tax-exempt income is the *policyholders' share* that reduces S's deduction for increase in reserves.

(b) *Tax-exempt items generally.* Under paragraph (b)(3)(i) of this section, S has \$200 of taxable income for Year 1. Also for Year 1, S has \$100 of tax-exempt income under paragraph (b)(3)(ii)(A) of this section, and another \$300 is treated as tax-exempt income under paragraph (b)(3)(ii)(B) of this section because of the deduction under section 806. Under paragraph (b)(3)(iii) of this section, S has \$40 of noncapital, nondeductible expenses for Year 1 because S's deduction under section 807 for its increase in reserves has been permanently reduced by the \$40 policyholders' share of the tax-exempt interest income. Thus, P increases its basis in S's stock by \$560 under paragraph (b) of this section.

(c) *Recapture.* Assume instead that S is a property and casualty company and, for Year

1, S accrues \$100 of estimated salvage recoverable under section 832. Of this amount, \$87 (87% of \$100) is excluded from gross income because of the "fresh start" provisions of Sec. 11305(c) of P.L. 101-508 (the Omnibus Budget Reconciliation Act of 1990). Thus, S has \$87 of tax-exempt income under paragraph (b)(3)(ii)(A) of this section that increases P's basis in S's stock for Year 1. (S also has \$13 of taxable income over the period of inclusion under section 481.) In Year 5, S determines that the \$100 salvage recoverable was overestimated by \$30 and deducts \$30 for the reduction of the salvage recoverable. However, S has \$26.10 (87% of \$30) of taxable income in Year 5 due to the partial recapture of its fresh start. Because S has no basis corresponding to this income, S is treated under paragraph (b)(3)(iii)(B) of this section as having a \$26.10 noncapital, nondeductible expense in Year 5. This treatment is necessary to reflect the elimination of the erroneous fresh start in S's stock basis and causes a decrease in P's basis in S's stock by \$30 for Year 5 (a \$3.90 taxable loss and a \$26.10 special adjustment).

(c) *Allocation of adjustments among shares of stock*—(1) *In general.* The portion of the adjustment under paragraph (b) of this section that is described in paragraph (b)(2)(iv) of this section (negative adjustments for distributions) is allocated to the shares of S's stock to which the distribution relates. The remainder of the adjustment, described in paragraphs (b)(2)(i) through (iii) of this section (adjustments for taxable income or loss, tax-exempt income, and noncapital, nondeductible expenses), is allocated among the shares of S's stock as provided in paragraphs (c)(2) through (4) of this section. If the remainder of the adjustment is positive, it is allocated first to any preferred stock to the extent provided in paragraph (c)(3) of this section, and then to the common stock as provided in paragraph (c)(2) of this section. If the remainder of the adjustment is negative, it is allocated only to common stock as provided in paragraph (c)(2) of this section. An adjustment under this section allocated to a share for the period the share is owned by a nonmember has no effect on the basis of the share. See paragraph (c)(4) of this section for the reallocation of adjustments, and paragraph (d) of this section for definitions. See § 1.1502-19(d) for special allocations of basis determined or adjusted under the Code with respect to excess loss accounts.

(2) *Common stock*—(i) *Allocation within a class.* The portion of the adjustment described in paragraphs (b)(2)(i) through (iii) of this section (the adjustment determined without taking distributions into account) that is allocable to a class of common stock is generally allocated equally to each share within the class. However, if a member has an excess loss account in shares of a class of common stock at the time of a positive adjustment, the portion of the adjustment allocable to the member with respect to the class is allocated first to equalize and eliminate that member's excess loss accounts and then to increase equally its basis in the shares of that class. Similarly, any negative adjustment is allocated first to reduce the member's positive basis in shares of the class before creating or increasing its excess loss account. Distributions and any adjustments or determinations under the Internal Revenue Code (e.g., under section 358, including any modifications under § 1.1502-19(d)) are taken into account before the allocation is made under this paragraph (c)(2)(i).

(ii) *Allocation among classes*—(A) *General rule.* If S has more than one class of common stock, the extent to which the adjustment described in paragraphs (b)(2)(i) through (iii) of this section (the adjustment determined without taking distributions into account) is allocated to each class is determined, based on consistently applied assumptions, by taking into account the terms of each class and all other facts and circumstances relating to the overall economic arrangement. The allocation generally must reflect the manner in which the classes participate in the economic benefit or burden (if any) corresponding to the items of income, gain, deduction, or loss allocated. In determining participation, any differences in voting rights are not taken into account, and the following factors are among those to be considered—

(1) The interest of each share in economic profits and losses (if different from the interest in taxable income);

(2) The interest of each share in cash flow and other non-liquidating distributions; and

(3) The interest of each share in distributions in liquidation.

(B) *Distributions and Code adjustments.* Distributions and any adjustments or determinations under the Internal Revenue Code are taken into account before the allocation is made under this paragraph (c)(2)(ii).

(3) *Preferred stock.* If the adjustment under paragraphs (b)(2)(i) through (iii) of this section (the adjustment determined without taking distributions into account) is positive, it is allocated to preferred stock to the extent required (when aggregated with prior allocations to the preferred stock during the period that S is a member of the consolidated group) to reflect distributions described in section 301 (and all other distributions treated as dividends) to which the preferred stock becomes entitled, and arrearages arising, during the period that S is a member of the consolidated group. For this purpose, the preferred stock is treated as entitled to a distribution no later than the time the distribution is taken into account under the Internal Revenue Code (e.g., under section 305). If the amount of distributions and arrearages exceeds the positive amount (when aggregated with prior allocations), the positive amount is first allocated among classes of preferred stock to reflect their relative priorities, and the amount allocated to each class is then allocated pro rata within the class. An allocation to a share with respect to arrearages and distributions for the period the share is owned by a nonmember is not reflected in the basis of the share under paragraph (b) of this section. However, if P and S cease to be members of one consolidated group and remain affiliated as members of another consolidated group, P's ownership of S's stock during consolidated return years of the prior group is treated for this purpose as ownership by a member to the extent that the adjustments during the prior consolidated return years are still reflected in the basis of the preferred stock.

(4) *Cumulative redetermination*—(i) *General rule.* A member's basis in each share of S's preferred and common stock must be redetermined whenever necessary to determine the tax liability of any person. See paragraph (b)(1) of this section. The redetermination is made by reallocating S's net adjust-

ment described in paragraphs (b)(2)(i) through (iii) of this section (the adjustment determined without taking distributions into account) for each consolidated return year (or other applicable period) of the group by taking into account all of the facts and circumstances affecting allocations under this paragraph (c) as of the redetermination date with respect to all of S's shares. For this purpose:

(A) Amounts may be reallocated from one class of S's stock to another class, but not from one share of a class to another share of the same class.

(B) If there is a change in the equity structure of S (e.g., as the result of S's issuance, redemption, or recapitalization of shares), a cumulative redetermination is made for the period before the change. If a reallocation is required by another redetermination after a change, amounts arising after the change are reallocated before amounts arising before the change.

(C) If S becomes a nonmember as a result of a change in its equity structure, any reallocation is made only among the shares of S's stock immediately before the change. For example, if S issues stock to a nonmember creditor in exchange for its debt, and the exchange results in S becoming a nonmember, any reallocation is only among the shares of S's stock immediately before the exchange.

(D) Any reallocation is treated for all purposes after it is made (including subsequent redeterminations) as the original allocation of an amount under this paragraph (c), but the reallocation does not affect any prior period.

(ii) *Prior use of allocations.* An amount may not be reallocated under paragraph (c)(4)(i) of this section to the extent that the amount has been used before the reallocation. For this purpose, an amount has been used to the extent it has been taken into account, directly or indirectly, by any member in determining income, gain, deduction, or loss, or in determining the basis of any property that is not subject to this section (e.g., stock of a corporation that has become a nonmember). For example, if P sells a share of S stock, an amount previously allocated to the share cannot be reallocated to another

share of S stock, but an amount allocated to another share of S stock can still be reallocated to the sold share because the reallocated amount has not been taken into account; however, any adjustment reallocated to the sold share may effectively be eliminated, because the reallocation was not in effect when the share was previously sold and P's gain or loss from the sale is not redetermined. If, however, P sells the share of S stock to another member, the amount is not used until P's gain or loss is taken into account under § 1.1502-13.

(5) *Examples.* The principles of this paragraph (c) are illustrated by the following examples.

*Example 1. Ownership of less than all the stock.* (a) *Facts.* P owns 80% of S's only class of stock with an \$800 basis. For Year 1, S has \$100 of taxable income.

(b) *Analysis.* Under paragraph (c)(1) of this section, the \$100 positive adjustment under paragraph (b) of this section for S's taxable income is allocated among the shares of S's stock, including shares owned by nonmembers. Under paragraph (c)(2)(i) of this section, the adjustment is allocated equally to each share of S's stock. Thus, P increases its basis in S's stock under paragraph (b) of this section as of the close of Year 1 by \$80. (The basis of the 20% of S's stock owned by nonmembers is not adjusted under this section.)

(c) *Varying interest.* The facts are the same as in paragraph (a) of this *Example 1*, except that P buys the remaining 20% of S's stock at the close of business on June 30 of Year 1 for \$208. Under paragraph (b)(1) of this section and the principles of § 1.1502-76(b), S's \$100 of taxable income is allocable \$40 to the period from January 1 to June 30 and \$60 to the period from July 1 to December 31. Thus, for the period ending June 30, P is treated as having a \$32 adjustment with respect to the S stock that P has owned since January 1 (80% of \$40) and, under paragraph (c)(2)(i) of this section, the adjustment is allocated equally among those shares. For the period ending December 31, P is treated as having a \$60 adjustment (100% of \$60) that is also allocated equally among P's shares of S's stock owned after June 30. P's basis in the shares owned as of the beginning of the year therefore increases by \$80 (the sum of 80% of \$40 and 80% of \$60), from \$800 to \$880, and P's basis in the shares purchased on June 30 increases by \$12 (20% of \$60), from \$208 to \$220. Thus, P's aggregate basis in S's stock as of the end of Year 1 is \$1,100.

(d) *Tax liability.* The facts are the same as in paragraph (a) of this *Example 1*, except that P pays S's \$34 share of the group's consolidated tax liability resulting from S's tax-

able income, and S does not reimburse P. S's \$100 of taxable income results in a positive adjustment under paragraph (b)(3)(i) of this section, and S's \$34 of tax liability results in a negative adjustment under paragraph (b)(3)(iv)(D) of this section and the principles of section 1552. Because S does not make any payment in recognition of the additional tax liability, by analogy to the treatment under § 1.1552-1(b)(2), S is treated as having made a \$34 payment that is described in paragraph (b)(3)(iii) of this section (noncapital, non-deductible expenses) and as having received an equal amount from P as a capital contribution. Thus, P increases its basis in its S stock by \$52.80 (80% of the \$100 of taxable income, less 80% of the \$34 tax payment). In addition, P increases its basis in S's stock by \$34 under the Internal Revenue Code and paragraph (a)(2) of this section to reflect the capital contribution. In the aggregate, P increases its basis in S's stock by \$86.80. (If, as in paragraph (c) of this *Example 1*, P buys the remaining 20% of S's stock at the close of business on June 30, P increases its basis in S's stock by another \$7.90 for the additional 20% interest in S's income after June 30 (\$60 multiplied by 20%, less 20% of the \$20.40 tax payment on \$60); the \$34 capital contribution by P is reflected in all of its S shares (not just the original 80%), and P's aggregate basis adjustment under this section is \$94.70 (\$86.80 plus \$7.90).)

*Example 2. Preferred stock.* (a) *Facts.* P owns all of S's common stock with an \$800 basis, and nonmembers own all of S's preferred stock. The preferred stock was issued for \$200, has a \$20 annual, cumulative preference as to dividends, and has an initial liquidation preference of \$200. For Year 1, S has \$50 of taxable income and no distributions are declared or made.

(b) *Analysis of arrearages.* Under paragraphs (c) (1) and (3) of this section, \$20 of the \$50 positive adjustment under paragraph (b) of this section is allocated first to the preferred stock to reflect the dividend arrearage arising in Year 1. The remaining \$30 of the positive adjustment is allocated to the common stock, increasing P's basis from \$800 to \$830 as of the close of Year 1. (The basis of the preferred stock owned by nonmembers is not adjusted under this section.)

(c) *Current distribution.* The facts are the same as in paragraph (a) of this *Example 2*, except that S declares and makes a \$20 distribution with respect to the preferred stock during Year 1 in satisfaction of its preference. The results are the same as in paragraph (b) of this *Example 2*.

(d) *Varying interest.* The facts are the same as in paragraph (a) of this *Example 2*, except that S has no income or loss for Years 1 and 2, P purchases all of S's preferred stock at the beginning of Year 3 for \$240, and S has \$70 of taxable income for Year 3. Under paragraph (c)(3) of this section, \$60 of the \$70

positive adjustment under paragraph (b) of this section is allocated to the preferred stock to reflect the dividends arrearages for Years 1 through 3, but only the \$20 for Year 3 is reflected in the basis of the preferred stock under paragraph (b) of this section. (The remaining \$40 is not reflected because the preferred stock was owned by nonmembers during Years 1 and 2.) Thus, P increases its basis in S's preferred stock from \$240 to \$260, and its basis in S's common stock from \$800 to \$810, as of the close of Year 3. (If P had acquired all of S's preferred stock in a transaction to which section 351 applies, and P's initial basis in S's preferred stock was \$200 under section 362, P's basis in S's preferred stock would increase from \$200 to \$220.)

(e) *Varying interest with current distributions.* The facts are the same as in paragraph (d) of this *Example 2*, except that S declares and makes a \$20 distribution with respect to the preferred stock in each of Years 1 and 2 in satisfaction of its preference, and P purchases all of S's preferred stock at the beginning of Year 3 for \$200. Under paragraph (c)(3) of this section, \$40 of the \$70 positive adjustment under paragraph (b) of this section is allocated to the preferred stock to reflect the distributions in Years 1 and 2, and \$20 of the \$70 is allocated to the preferred stock to reflect the arrearage for Year 3. However, as in paragraph (d) of this *Example 2*, only the \$20 attributable to Year 3 is reflected in the basis of the preferred stock under paragraph (b) of this section. Thus, P increases its basis in S's preferred stock from \$200 to \$220, and P increases its basis in S's common stock from \$800 to \$810.

*Example 3. Cumulative redetermination.* (a) *Facts.* P owns all of S's common and preferred stock. The preferred stock has a \$100 annual, cumulative preference as to dividends. For Year 1, S has \$200 of taxable income, the first \$100 of which is allocated to the preferred stock and the remaining \$100 of which is allocated to the common stock. For Year 2, S has no adjustment under paragraph (b) of this section, and P sells all of S's common stock at the close of Year 2.

(b) *Analysis.* Under paragraph (c)(4) of this section, P's basis in S's common stock must be redetermined as of the sale of the stock. The redetermination is made by reallocating the \$200 positive adjustment under paragraph (b) of this section for Year 1 by taking into account all of the facts and circumstances affecting allocations as of the sale. Thus, the \$200 positive adjustment for Year 1 is reallocated entirely to the preferred stock to reflect the dividend arrearages for Years 1 and 2. The reallocation away from the common stock reflects the fact that, because of the additional amount of arrearage in Year 2, the common stock is not entitled to any part of the \$200 of taxable income from Year 1. Thus, the common stock has no positive or

negative adjustment, and the preferred stock has a \$200 positive adjustment. These reallocations are treated as the original allocations for Years 1 and 2. (The results for the common stock would be the same if the common and preferred stock were not owned by the same member, or the preferred stock were owned by nonmembers.)

(c) *Preferred stock issued after adjustment arises.* The facts are the same as in paragraph (a) of this *Example 3*, except that S does not issue its preferred stock until the beginning of Year 2, S has no further adjustment under paragraph (b) of this section for Years 2 and 3, and P sells S's common stock at the close of Year 3. Under paragraphs (c) (1) and (2) of this section, the \$200 positive adjustment for Year 1 is initially allocated entirely to the common stock. Under paragraph (c)(4) of this section, the \$200 adjustment is reallocated to the preferred stock to reflect the arrearages for Years 2 and 3. Thus, the common stock has no positive or negative adjustment.

(d) *Common stock issued after adjustment arises.* The facts are the same as in paragraph (a) of this *Example 3*, except that S has no preferred stock, S issues additional common stock of the same class at the beginning of Year 2, S has no further adjustment under paragraph (b) of this section in Years 2 and 3, and P sells its S common stock at the close of Year 3. Under paragraphs (c) (1) and (2) of this section, the \$200 positive adjustment for Year 1 is initially allocated entirely to the original common stock. Under paragraph (c)(4)(i)(A) of this section, the \$200 adjustment is not reallocated among the original common stock and the additional stock. Unlike the preferred stock in paragraph (c) of this *Example 3*, the additional common stock is of the same class as the original stock, and there is no reallocation between shares of the same class.

(e) *Positive and negative adjustments.* The facts are the same as in paragraph (a) of this *Example 3*, except that S has a \$200 loss for Year 2 that results in a negative adjustment to the common stock before any redetermination. For purposes of the basis redetermination under paragraph (c)(4) of this section, the Year 1 and 2 adjustments under paragraph (b) of this section are not netted. Thus, as in paragraph (b) of this *Example 3*, the redetermination is made by reallocating the \$200 positive adjustment for Year 1 entirely to the preferred stock. The \$200 negative adjustment for Year 2 is allocated entirely to the common stock. Consequently, the preferred stock has a \$200 positive cumulative adjustment, and the common stock has a \$200 negative cumulative adjustment. (The results would be the same if there were no other adjustments described in paragraph (b) of this section, P sells S's common stock at the close of Year 3 rather than Year 2, and an additional \$100 arrearage arises in Year 3; only adjustments under paragraph (b) of this

section may be reallocated, and there is no additional adjustment for Year 3.)

(f) *Current distributions.* The facts are the same as in paragraph (a) of this *Example 3*, except that, during Year 1, S declares and makes a distribution to P of \$100 as a dividend on the preferred stock and \$100 as a dividend on the common stock. The taxable income and distributions result in no Year 1 adjustment under paragraph (b) of this section for either the common or preferred stock. For example, if T merges into S, S is treated, as the context may require, as a successor to T and as becoming a member of the group. However, as in paragraph (b) of this *Example 3*, the redetermination under paragraph (c)(4) of this section is made by reallocating a \$200 positive adjustment for Year 1 (S's net adjustment described in paragraph (b) of this section, determined without taking distributions into account) to the preferred stock. Consequently, the preferred stock has a \$100 positive cumulative adjustment (\$200 of taxable income, less a \$100 distribution with respect to the preferred stock) and the common stock has a \$100 negative cumulative adjustment (for the distribution).

(g) *Convertible preferred stock.* The facts are the same as in paragraph (a) of this *Example 3*, except that the preferred stock is convertible into common stock that is identical to the common stock already outstanding, the holders of the preferred stock convert the stock at the close of Year 2, and no stock is sold until the close of Year 5. Under paragraph (c)(4) of this section, the \$200 positive adjustment for Year 1 is reallocated entirely to the preferred stock immediately before the conversion. The newly issued common stock is treated as a second class of S common stock, and adjustments under paragraph (b) of this section are allocated between the original and the new common stock under paragraph (c)(2)(ii) of this section. Although the preferred stock is converted to common stock, the \$200 adjustment to the preferred stock is not subsequently reallocated between the original and the new common stock. Because the original and the new stock are equivalent, adjustments under paragraph (b) of this section for subsequent periods are allocated equally to each share.

(h) *Prior use of allocations.* The facts are the same as in paragraph (a) of this *Example 3*, except that P sells 10% of S's common stock at the close of Year 1, and the remaining 90% at the close of Year 2. P's basis in the common stock sold in Year 1 reflects \$10 of the adjustment allocated to the common stock for Year 1. Under paragraph (c)(4)(ii) of this section, because \$10 of the Year 1 adjustment was used in determining P's gain or loss, only \$90 is reallocated to the preferred stock, and \$10 remains allocated to the common stock sold.

(i) *Lower-tier members.* The facts are the same as in paragraph (a) of this *Example 3*, except that P owns only S's common stock, and P is also a subsidiary. If there is a redetermination under paragraph (c)(4) of this section by a member owning P's stock, a redetermination with respect to S's stock must be made first, and the effect of that redetermination on P's adjustments is taken into account under paragraph (b) of this section. However, as in paragraph (h) of this *Example 3*, to the extent an amount of the initial adjustments with respect to S's common stock have already been tiered up and used by a member owning P's stock, that amount remains with S's common stock (and the higher-tier member using the adjustment with respect to P's stock), and may not be reallocated to S's preferred stock.

*Example 4. Allocation to preferred stock between groups.* (a) *Facts.* P owns all of S's only class of stock, and S owns all of T's common and preferred stock. The preferred stock has a \$100 annual, cumulative preference as to dividends. For Year 1, T has \$200 of taxable income, the first \$100 of which is allocated to the preferred stock and the remaining \$100 of which is allocated to the common stock, and S has no adjustments other than the amounts tiered up from T. S and T have no adjustments under paragraph (b) of this section for Years 2 and 3. X, the common parent of another consolidated group, purchases all of S's stock at the close of Year 3, and S and T become members of the X group. For Year 4, T has \$200 of taxable income, and S has no adjustments other than the amounts tiered up from T.

(b) *Analysis for Years 1 through 3.* Under paragraph (c)(4) of this section, the allocation of S's adjustments under paragraph (b) of this section (determined without taking distributions into account) must be redetermined as of the time P sells S's stock. As a result of this redetermination, T's common stock has no positive or negative adjustment and the preferred stock has a \$200 positive adjustment.

(c) *Analysis for Year 4.* Under paragraph (c)(3) of this section, the allocation of T's \$200 positive adjustment in Year 4 to T's preferred stock with respect to arrearages is made by taking into account the consolidated return years of both the P group and the X group. Thus, the allocation of the \$200 positive adjustment for Year 4 to T's preferred stock is not treated as an allocation for a period for which the preferred stock is owned by a nonmember. Thus, the \$200 adjustment is reflected in S's basis in T's preferred stock under paragraph (b) of this section.

(d) *Definitions.* For purposes of this section—

(1) *Class.* The shares of a member having the same material terms (without taking into account voting rights) are treated as a single class of stock.

(2) *Preferred stock.* Preferred stock is stock that is limited and preferred as to dividends and has a liquidation preference. A class of stock that is not described in section 1504(a)(4), however, is not treated as preferred stock for purposes of paragraph (c) of this section if members own less than 80% of each class of common stock (determined without taking this paragraph (d)(2) into account).

(3) *Common stock.* Common stock is stock that is not preferred stock.

(4) *Becoming a nonmember.* A member is treated as becoming a nonmember if it has a separate return year (including another group's consolidated return year). For example, S may become a nonmember if it issues additional stock to nonmembers, but S does not become a nonmember as a result of its complete liquidation.

(e) *Anti-avoidance rule—(1) General rule.* If any person acts with a principal purpose contrary to the purposes of this section, to avoid the effect of the rules of this section or apply the rules of this section to avoid the effect of any other provision of the consolidated return regulations, adjustments must be made as necessary to carry out the purposes of this section.

(2) *Examples.* The principles of this paragraph (e) are illustrated by the following examples.

*Example 1. Preferred stock treated as common stock.* (a) *Facts.* S has 100 shares of common stock and 100 shares of preferred stock described in section 1504(a)(4). P owns 80 shares of S's common stock and all of S's preferred stock. The shareholders expect that S will have negative adjustments under paragraph (b) of this section for Years 1 and 2 (all of which will be allocable to S's common stock), the negative adjustments will have no significant effect on the value of S's stock, and S will have offsetting positive adjustments thereafter. When the preferred stock was issued, P intended to cause S to recapitalize the preferred stock into additional common stock at the end of Year 2 in a transaction described in section 368(a)(1)(E). P's temporary ownership of the preferred stock is with a principal purpose to limit P's basis reductions under paragraph (b) of this section to 80% of the anticipated negative adjustments. The recapitalization

is intended to cause significantly more than 80% of the anticipated positive adjustments to increase P's basis in S's stock because of P's increased ownership of S's common stock immediately after the recapitalization.

(b) *Analysis.* S has established a transitory capital structure with a principal purpose to enhance P's basis in S's stock under this section. Under paragraph (e)(1) of this section, all of S's common and preferred stock is treated as a single class of common stock in Years 1 and 2 for purposes of this section. Thus, S's items are allocated under the principles of paragraph (c)(2)(ii) of this section, and P decreases its basis in both the common and preferred stock accordingly.

*Example 2. Contribution of appreciated property.* (a) *Facts.* P owns all of the stock of S and T, and S and T each own 50% of the stock of U. P's S stock has a \$150 basis and \$200 value, and P's T stock has a \$200 basis and \$200 value. With a principal purpose to eliminate P's gain from an anticipated sale of S's stock, T contributes to U an asset with a \$100 value and \$0 basis, and S contributes \$100 cash. U sells T's asset and recognizes a \$100 gain that results in a \$100 positive adjustment under paragraph (b) of this section.

(b) *Analysis.* Under paragraph (c)(2) of this section, U's adjustment ordinarily would be allocated equally to each share of U's stock. If so allocated, P's basis in S's stock would increase from \$150 to \$200 and P would recognize no gain from the sale of S's stock for \$200. Under paragraph (e)(1) of this section, however, because T transferred an appreciated asset to U with a principal purpose to shift a portion of the stock basis increase from P's stock in T to P's stock in S, the allocation of the \$100 positive adjustment under paragraph (c) of this section between the shares of U's stock must take into account the contribution. Consequently, all \$100 of the positive adjustment is allocated to the U stock owned by T, rather than \$50 to the U stock owned by S and \$50 to the U stock owned by T. P's basis in S's stock remains \$150, and its basis in T's stock increases to \$300. Thus, P recognizes a \$50 gain from its sale of S's stock for \$200.

*Example 3. Reorganizations.* (a) *Facts.* P forms S with an \$800 contribution, \$200 of which is in exchange for S's preferred stock described in section 1504(a)(4) and the balance of which is for S's common stock. For Years 1 through 3, S has a total of \$160 of ordinary income, \$60 of which is distributed with respect to the preferred stock in satisfaction of its \$20 annual preference as to dividends. Under this section, P's basis in S's preferred stock is unchanged, and its basis in S's common stock is increased from \$600 to \$700. To reduce its gain from an anticipated sale of S's preferred stock, P forms T at the close of Year 3 with a contribution of all of

S's stock in exchange for corresponding common and preferred stock of T in a transaction to which section 351 applies. At the time of the contribution, the fair market value of the common stock is \$700 and the fair market value of the preferred stock is \$300 (due to a decrease in prevailing market interest rates). P subsequently sells T's preferred stock for \$300.

(b) *Analysis.* Under section 358(b), P ordinarily has a \$630 basis in T's common stock (70% of the \$900 aggregate stock basis) and a \$270 basis in T's preferred stock (30% of the \$900 aggregate stock basis). However, because P transferred S's stock to T with a principal purpose to shift the allocation of basis adjustments under this section, adjustments are made under paragraph (e)(1) of this section to preserve the allocation under this section. Thus, P has a \$700 basis in T's common stock and a \$200 basis in T's preferred stock. Consequently, P recognizes a \$100 gain from the sale of T's preferred stock.

*Example 4. Post-deconsolidation basis adjustments.* (a) *Facts.* For Year 1, the P group has \$40 of taxable income when determined by including only S's items of income, gain, deduction, and loss taken into account, and P increases its basis in S's stock by \$40 under paragraph (b) of this section. P anticipates that S will have a \$40 ordinary loss for Year 2 that will be carried back and offset S's income in Year 1 and result in a \$40 reduction to P's basis in S's stock for Year 2 under paragraph (b) of this section. With a principal purpose to avoid the reduction, P causes S to issue voting preferred stock that results in S becoming a nonmember at the beginning of Year 2. (Section 1.1502-20(b) does not reduce P's basis in the S stock as a result of S's deconsolidation.) As anticipated, S has a \$40 loss for Year 2, which is carried back to Year 1 and offsets S's income from Year 1.

(b) *Analysis.* Under paragraph (e)(1) of this section, because P caused S to become a nonmember with a principal purpose to absorb S's loss but avoid the corresponding negative adjustment under this section, and P bears a substantial portion of the loss because of its continued ownership of S common stock, the basis of P's common stock in S is decreased by \$40 for Year 2. (If P has less than a \$40 basis in the retained S stock, P must recognize income for Year 2 to the extent of the excess.) Section 1504(a)(3) limits the ability of S to subsequently rejoin the P group's consolidated return.

(c) *Carryback to pre-consolidation year.* The facts are the same as in paragraph (a) of this *Example 4*, except that P anticipates that S's loss will be carried back and absorbed in a separate return year of S before Year 1 (rather than to the P group's consolidated return for Year 1). Although P causes S to become a nonmember with a principal purpose to avoid the negative adjustment under this

section, and P bears a substantial portion of the loss because of its continued ownership of S common stock, both S's income and loss are taken into account under the separate return rules. Consequently, no one has acted with a principal purpose contrary to the purposes of this section, and no adjustments are necessary to carry out the purposes of this section.

*Example 5. Pre-consolidation basis adjustments.* (a) *Facts.* P forms S with a \$100 contribution, and S becomes a member of the P affiliated group which does not file consolidated returns. For Years 1 through 3, S earns \$300. P anticipates that it will elect under section 1501 for the P group to begin filing consolidated returns in Year 5. In anticipation of filing consolidated returns, and to avoid the negative stock basis adjustment that would result under paragraph (b) of this section from distributing S's earnings after Year 5, P causes S to distribute \$300 during Year 4 as a qualifying dividend within the meaning of section 243(b). There is no plan or intention to recontribute the funds to S after the distribution.

(b) *Analysis.* Although S's distribution of \$300 is with a principal purpose to avoid a corresponding negative adjustment under this section, the \$300 was both earned and distributed entirely under the separate return rules. Consequently, P and S have not acted with a principal purpose contrary to the purposes of this section, and no adjustments are necessary to carry out the purposes of this section.

(f) *Predecessors and successors.* For purposes of this section, any reference to a corporation or to a share of stock includes a reference to a successor or predecessor as the context may require. A corporation is a successor if the basis of its assets is determined, directly or indirectly, in whole or in part, by reference to the basis of another corporation (the predecessor). For example, if T merges into S, S is treated, as the context may require, as a successor to T and as becoming a member of the group. A share is a successor if its basis is determined, directly or indirectly, in whole or in part, by reference to the basis of another share (the predecessor).

(g) *Recordkeeping.* Adjustments under this section must be reflected annually on permanent records (including work papers). See also section 6001, requiring records to be maintained. The group must be able to identify from these permanent records the amount and allocation of adjustments, including the nature of any tax-exempt income and



noncapital, nondeductible expenses, so as to permit the application of the rules of this section for each year.

(h) *Effective date*—(1) *General rule.* This section applies with respect to determinations of the basis of the stock of a subsidiary (e.g., for determining gain or loss from a disposition of stock) in consolidated return years beginning on or after January 1, 1995. If this section applies, basis must be determined or redetermined as if this section were in effect for all years (including, for example, the consolidated return years of another consolidated group to the extent adjustments from those years are still reflected). For example, if the portion of a consolidated net operating loss carryover attributable to S expired in 1990 and is treated as a noncapital, nondeductible expense under paragraph (b) of this section, it is taken into account in tax years beginning on or after January 1, 1995 as a negative adjustment for 1990. Any such determination or redetermination does not, however, affect any prior period. Thus, the negative adjustment for S's noncapital, nondeductible expense is not taken into account for tax years beginning before January 1, 1995.

(2) *Dispositions of stock before effective date*—(i) *In general.* If P disposes of stock of S in a consolidated return year beginning before January 1, 1995, the amount of P's income, gain, deduction, or loss, and the basis reflected in that amount, are not redetermined under this section. See § 1.1502-19 as contained in the 26 CFR part 1 edition revised as of April 1, 1994 for the definition of disposition, and paragraph (h)(5) of this section for the rules applicable to such dispositions.

(ii) *Lower-tier members.* Although P disposes of S's stock in a tax year beginning before January 1, 1995, S's determinations or adjustments with respect to the stock of a lower-tier member with which it continues to file a consolidated return are redetermined in accordance with the rules of this section (even if they were previously taken into account by P and reflected in income, gain, deduction, or loss from the disposition of S's stock). For example, assume that P owns all of S's stock, S owns all of T's stock, and T owns all of U's stock. If S sells 80% of

T's stock in a tax year beginning before January 1, 1995 (the effective date), the amount of S's income, gain, deduction, or loss from the sale, and the stock basis adjustments reflected in that amount, are not redetermined if P sells S's stock after the effective date. If S sells the remaining 20% of T's stock after the effective date, S's stock basis adjustments with respect to that T stock are also not redetermined because T became a nonmember before the effective date. However, if T and U continue to file a consolidated return with each other and T sells U's stock after the effective date, T's stock basis adjustments with respect to U's stock are redetermined (even though some of those adjustments may have been taken into account by S in its prior sale of T's stock before the effective date).

(iii) *Deferred amounts.* For purposes of this paragraph (h)(2), a disposition does not include a transaction to which § 1.1502-13, § 1.1502-13T, § 1.1502-14, or § 1.1502-14T applies. Instead, the transaction is deemed to occur as the income, gain, deduction, or loss (if any) is taken into account.

(3) *Distributions*—(i) *Deemed dividend elections.* If there is a deemed distribution and recontribution pursuant to § 1.1502-32(f)(2) as contained in the 26 CFR part 1 edition revised as of April 1, 1994 in a consolidated return year beginning before January 1, 1995, the deemed distribution and recontribution under the election are treated as an actual distribution by S and recontribution by P as provided under the election.

(ii) *Affiliated earnings and profits.* This section does not apply to reduce the basis in S's stock as a result of a distribution of earnings and profits accumulated in separate return years, if the distribution is made in a consolidated return year beginning before January 1, 1995, and the distribution does not cause a negative adjustment under the investment adjustment rules in effect at the time of the distribution. See paragraph (h)(5) of this section for the rules in effect with respect to the distribution.

(4) *Expiring loss carryovers.* If S became a member of a consolidated group in a consolidated return year beginning

before January 1, 1995, and S had a loss carryover from a separate return limitation year at that time, the group does not treat any expiration of the loss carryover (even if in a tax year beginning on or after January 1, 1995) as a noncapital, nondeductible expense resulting in a negative adjustment under this section. If S becomes a member of a consolidated group in a consolidated return year beginning on or after January 1, 1995, and S has a loss carryover from a separate return limitation year at that time, adjustments with respect to the expiration are determined under this section.

(5) *Prior law*—(i) *In general*. For prior determinations, see prior regulations under section 1502 as in effect with respect to the determination. See, e.g., §§1.1502-32 and 1.1502-32T as contained in the 26 CFR part 1 edition revised as of April 1, 1994.

(ii) *Continuing basis reductions for certain deconsolidated subsidiaries*. If a subsidiary ceases to be a member of a group in a consolidated return year beginning before January 1, 1995, and its basis was subject to reduction under §1.1502-32T or §1.1502-32(g) as contained in the 26 CFR part 1 edition revised as of April 1, 1994, its basis remains subject to reduction under those principles. For example, if S ceased to be a member in 1990, and P's basis in any retained S stock was subject to a basis reduction account, the basis remains subject to reduction. Similarly, if an election could be made to apply §1.1502-32T instead of §1.1502-32(g), the election remains available. However, §§1.1502-32T and 1.1502-32(g) do not apply as a result of a subsidiary ceasing to be a member in tax years beginning on or after January 1, 1995.

[T.D. 8560, 59 FR 41685, Aug. 15, 1994, as amended by T.D. 8677, 61 FR 33323, June 27, 1996; T.D. 8560, 62 FR 12098, Mar. 14, 1997; T.D. 8823, 64 FR 36099, July 2, 1999]

#### § 1.1502-33 Earnings and profits.

(a) *In general*—(1) *Purpose*. This section provides rules for adjusting the earnings and profits of a subsidiary (S) and any member (P) owning S's stock. These rules modify the determination of P's earnings and profits under applicable rules of law, including section 312, by adjusting P's earnings and prof-

its to reflect S's earnings and profits for the period that S is a member of the consolidated group. The purpose for modifying the determination of earnings and profits is to treat P and S as a single entity by reflecting the earnings and profits of lower-tier members in the earnings and profits of higher-tier members and consolidating the group's earnings and profits in the common parent. References in this section to earnings and profits include deficits in earnings and profits.

(2) *Application of other rules of law*. The rules of this section are in addition to other rules of law. For example, the allowance for depreciation is determined in accordance with section 312(k). P's earnings and profits must not be adjusted under this section and other rules of law in a manner that has the effect of duplicating an adjustment. For example, if S's earnings and profits are reflected in P's earnings and profits under paragraph (b) of this section, and S transfers its assets to P in a liquidation to which section 332 applies, S's earnings and profits that P succeeds to under section 381 must be adjusted to prevent duplication.

(b) *Tiering up earnings and profits*—(1) *General rule*. P's earnings and profits are adjusted under this section to reflect changes in S's earnings and profits in accordance with the applicable principles of §1.1502-32, consistently applied, and an adjustment to P's earnings and profits for a tax year under this paragraph (b)(1) is treated as earnings and profits of P for the tax year in which the adjustment arises. Under these principles, for example, the adjustments are made as of the close of each consolidated return year, and as of any other time if a determination at that time is necessary to determine the earnings and profits of any person. Similarly, S's earnings and profits are allocated under the principles of §1.1502-32(c), and the adjustments are applied in the order of the tiers, from the lowest to the highest. However, modifications to the principles include:

(i) The amount of P's adjustment is determined by reference to S's earnings and profits, rather than S's taxable and tax-exempt items (and therefore, for